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IRREGULAR ASSOCIATIONS.¹

The economic desire of men to associate in groups so organized as best to accomplish the purposes of their association is fully recognized and protected by our system of law. Associates may nowadays attain limited liability for one or all of their number, may acquire the right to sue and be sued in a common name, the right to make contracts and to do other acts in the name of the group, the right to receive, hold, and convey title to real estate, and the right to effectuate an organization such that the directors or other official representatives shall under ordinary circumstances alone be authorized to act for the group. Men are every day associating in the pursuit of some activity and are seeking to attain some or all of the privileges above enumerated. It is true that their association usually takes place with reference to some statute and that the steps which they

¹ This article is a preliminary study for a chapter on Irregular Associations in a work on the Law of Association which the writer has in course of preparation.

take to perfect their organization are taken in more or less strict compliance with statutory requirements. If, however, we say that the statute forms these groups, we are using language which, after all, is merely fictional. It is the individuals who possess the economic desire to associate upon certain terms and the organization of the association is their own act. The real question is not whether the state makes the association but whether the form of organization adopted by the associates shall be recognized as legitimate and whether effect shall be given to their desires. If the associates comply exactly with the terms upon which their association is legalized by some statute, an affirmative answer to this question will be given without hesitation. The difficulty arises when the associates fail to comply with some of the provisions of the statute or when it turns out that the statute does not sanction the particular kind of association that the associates undertake to form. Shall it be said that the inevitable consequence of non-compliance with the terms of the statute or of an absence of statutory authority is that no effect at all shall be given to the effort at association? Or shall it, on the other hand, be said that in private litigation between the associates and other citizens the question of compliance or non-compliance is immaterial: that the associates shall be recognized as possessing the privileges which they desire, subject to the right of the state to discipline them for their irregular action? Or shall a middle position be taken and shall the courts undertake to say that state sanction is essential to the valid exercise of the privileges but that there are degrees of non-compliance, and that while some irregularities are fatal to the claims of the associates other irregularities will not be so regarded? The problem is not dissimilar to that which arises respecting the nature and existence of the marriage status. A man and a woman live together and announce themselves to the world as husband and wife. They have failed to comply with the requirement of the state that marriage shall be solemnized before a designated official and only in pursuance of a license duly granted. Shall it be said that the failure to comply with the statutory requirement prevents

the parties from attaining the marriage status? Or shall it be said that it is the parties who make the marriage, not the state; and that the usual legal incidents will result from their association subject to the right of the state to punish the parties for their dereliction? In case of marriage we have no hesitation in rejecting the former and in accepting the latter view. Reasons in plenty may be given in support of the position that there is no greater justification for saying that the state makes corporations than for saying that the state makes marriages.²

Taking up in their order the questions suggested above respecting the effect of non-compliance with statutory requirements, it may be said that, except in a few instances to be hereafter considered, courts do not regard the mere fact of non-compliance as fatal to the claims of the associates. On the other hand, there is to be found in the books no definite recognition of the extreme view that the question of compliance or non-compliance is immaterial. While the tendency in this direction is definite and strong, the great majority of decided cases are the record of attempts to pursue a course between the two extremes and to draw a distinction between material and immaterial non-compliance. The obvious reason for this course is found in the persistence of the Concession Theory—the theory of those who hold that incorporation can be attained only by grant from the sovereign.

From the first, however, the pressure upon the courts has been uniform in the direction of according to associates the right to enjoy the advantages of the corporate status merely in virtue of the fact that they have organized a group on representative principles and are engaged in business in corporate form. The history of this branch of the law is the story of the way in which the courts have yielded to the pressure, all the while vainly trying to place limits to their concessions. In the decided cases the problem is not, of course, discussed in its abstract form, but always with refer-

² See Professor Maitland's Introduction (p. xxxvii) to Gierke's *Political Theories of the Middle Ages*. Cambridge: The University Press. 1900.

ence to the claim of a plaintiff that some particular corporate privilege or immunity is present or absent. The concrete questions which have arisen may be enumerated as follows: (I) Questions as to the *liability* of the associates: are they liable without limit as principals? (II) As to their right to make contracts and do other acts in the common name: is this mode of united action to be permitted to them? (III) As to their right to sue: may they sue in the common name? (IV) As to their amenability to suit: may they be sued in the common name? (V) As to the taking, holding, and conveying of title to property: may they receive conveyances and give deeds in the common name? (VI) As to their rights *inter sese*: may one invoke as against his fellows rights and remedies inconsistent with the status which they claim? It will be seen at a glance that the problem of *liability* is the one likely to present the greatest difficulty. This is true not only because of the importance to the associates of the question involved, but also because of the persistence of the common-law idea that every principal shall be liable without limit for his own acts and the acts of his representatives. In the discussion of the problem of limited liability we can see most clearly the working of two conflicting interests—the interest of the creditor to pursue his claim to full satisfaction and the interest of the associates to confine the creditor's recovery to the common property which they have embarked in the enterprise. Before beginning a consideration of the problems in the order given above, it should be noted that the significance of a decision which accords corporate rights to associates is directly proportioned to the strength of the common-law principle against which the associates happen to be contending. For a court to hold that associates may sue or be sued in a common name is a less important decision than to hold that a deed given by them in the common name operates to pass title and far less important than to hold that a creditor has no recourse to the separate estates of his debtors.

Attention should also be called to a matter of terminology. Irrespective of the theory upon which corporate privileges are conceded to persons irregularly associated, it is cus-

tomary to say that such persons are "a *de facto* corporation." The contrast is with persons regularly organized, who are said to be incorporated *de jure*. The term "*de facto* corporation" may have different meanings according to the view taken upon certain fundamental questions. If one adheres to the concession theory, the term means either nothing or that in spite of irregularities the associates have received corporate privilege from the state. The difficulties in the way of using this term consistently with the concession theory are obvious in cases where there is no law authorizing association or where the law is unconstitutional or where on rational principles of interpretation the associates have failed to satisfy conditions precedent to the grant. On the other hand, if one rejects the concession theory, the term implies that all corporate organization is in fact the act of the associates. Unlicensed corporate organization constitutes a group *de facto*. Licensed organization results in forming a group *de jure*—that is, in all respects according to legal requirement.

I. THE PROBLEM OF LIABILITY.—The question now to be discussed is whether in cases of irregular organization unlimited liability can be enforced against the associates as *principals*. It is sometimes said that the question is whether the associates are liable as *partners*. This statement of the problem is too narrow. The group may or may not be one which in the absence of statutory organization would be regarded as a partnership. B, C, and others associated themselves in corporate form for the purpose of having a public street graded, but they failed to comply with the requirements of the corporation law in certain respects which the court regarded as material. It did not appear that their association had profit for its object. B and C were chosen as secretary and vice-president of the association. In the common name a contract for doing the work of grading was made with X. A, a laborer, having quit work, was induced to return by the alleged promise of B and C that the association would pay him. He subsequently sued B, C, and other associates to recover his wages. A recovered a verdict. The court were of opinion that the case was not

one of partnership but that the liability of the defendants must rest upon ordinary principles of contract and agency. They were further of opinion that the question of fact respecting the agency of the defendants had been properly submitted to the jury.³ It is, of course, assumed that the liability of a principal cannot successfully be asserted against a defendant until the fact of agency has been established. In *Johnson v. Corser*, *supra*, one of the defendants had executed the articles of association but did not contribute or subscribe to the common fund and took no part in the organization. The court, however, left the question of his principalship to the jury because there was evidence tending to show that he knew that the work was being carried on in behalf of the associates and that he was present at the making of the agreement in suit. Where, however, there was no evidence that a defendant had taken any part in the business of an irregularly organized group and had given no authority to anyone to act for him, excepting such as could be inferred from the mere fact that he had signed the articles of incorporation, it was held to be error to leave the question of his liability to the jury.⁴

Let it now be assumed, as a typical case, that B, C, and others associate themselves in corporate form and claim the advantages specified in a certain chartering act. With some of the provisions of the act they fail to comply. They engage in business, buy goods in the common name from a plaintiff who deals with them in the belief that they are incorporated and are subsequently sued by him on the theory that the irregularity of their organization leaves them subject to the unlimited liability of principals. Assuming the fact of agency to be established, the plaintiff must succeed unless (1) the court inquires into the irregularity and is of opinion that it is so trivial that even the state could not take advantage of it; or unless (2) the court applies the principle that, whether or not the irregularity could be taken advantage of by the state, no one but the state can raise the question; or unless (3) the court applies

³ *Johnson v. Corser*, 34 Minn. 355 (1885).

⁴ *Rutherford v. Hill*, 22 Ore. 218 (1892).

some principle for the protection of the defendants other than the principle that they gain their immunity only from the state: as, for example, (a) that the plaintiff is *estopped* from asserting unlimited liability against them; or (b) that by his contract he has bound himself not to do so; or (c) that the defendants, by actually establishing a corporate organization, have secured a corporate status and, though subject to discipline by the state, are not subject to individual liability to the plaintiff.

1. Examining these theories in succession, it may be assumed that in the first case put the defendants have a valid defence. If the defect in organization is so trifling that a judgment of ouster would not be pronounced against the associates, of course they cannot be held liable by the plaintiff.⁵

2. In the second place, the court may decline to consider the irregularity at all, on the ground that to do so would be to inquire collaterally into acts done under the authority of a co-ordinate branch of the government—an inquiry which under certain circumstances the judiciary will decline to make. The reason for the rule against collateral attack is thus stated by Parsons:

“When the franchise was a direct grant made by the Executive or Legislative department, the charter was deemed the act of a co-ordinate branch of the Government, and, in deference to the Political Power, was treated as a judgment which could not be impeached collaterally.”⁶

Such being the principle (if principle it can be called), it might be contended that its application should be confined to the case of special grants of franchises by the legislature

⁵ For a discussion of the principles which should govern a court in determining whether or not the irregularities justify a judgment of ouster, see the opinion of Nelson, C. J., in *People v. Kingston and Middletown Turnpike*, 23 Wend. 193 (1840). For the distinction between cases in which the judgment should be a judgment of *seizure* and those in which *ouster* is proper, see 2 Kyd Corp. 408.

It is sometimes impossible to determine from an opinion whether the court regards the irregularities as too trivial to be attacked by the state or whether the court means that they are merely beyond the reach of private attack. See, for example, *Finnegan v. Norenberg*, 52 Minn. 239 (1893).

⁶ James Parsons on Partn. (2d Ed.) p. 96.

or the executive. If the principle were to be thus restricted it would have no application to cases in which the legislature sanctions self-incorporation under a general law. In other words, the principle would be inapplicable to the vast majority of the cases which to-day come before the courts. Such a restriction upon the application of the principle was recognized and enforced in *Paterson v. Arnold*.⁷

On the other hand, the principle might be extended in its application to all cases of organization under a legislative grant irrespective of whether the grant was special or general. The limitation recognized in *Paterson v. Arnold* was ignored five years later by the same court when the earlier decision was overruled.⁸ The modern cases which invoke the doctrine of collateral attack make no distinction between special charters and incorporation effected under general laws.

The principle which forbids collateral attack upon the regularity of the organization presupposes the existence of a law under which a regular organization might have been effected. Where, therefore, a law contained no sanction for the organization of a banking corporation it was held that associates who had assumed to organize under the law and had obtained from the executive authority a certificate of corporate existence were nevertheless liable to be put into bankruptcy individually at the petition of those who had deposited money in their bank.⁹ Whether an unconstitutional law affords sufficient basis for the application of the doctrine under consideration is a question upon which, as might be expected, judges have differed.¹⁰ The original basis for the rule forbidding collateral attack seems to have been long ago lost sight of. The doctrine is nowadays invoked merely

⁷ Pa. 410 (1863).

⁸ *Cochran v. Arnold*, 58 Pa. 399 (1868).

⁹ *Davis v. Stevens*, 104 ed. Rep. 235 (1900).

¹⁰ In favor of the view that when the law is unconstitutional the doctrine does not apply are *Eaton v. Walker*, 76 Mich. 579 (1889), and *Heaston v. Railroad Co.*, 16 Ind. 275 (1861). In favor of the view that the doctrine should be applied even where the law is invalid are *Winget v. Quincy, etc., Ass'n*, 128 Ill. 67 (1889); *Building, etc., Ass'n v. Chamberlain*, 4 S. D. 271 (1893); *Richards v. Minnesota Savings Bank*, 75 Minn. 196 (1899).

to furnish a reason for securing corporate privileges to associates where they have in fact formed a corporate organization. As the use of the doctrine has become merely fictional it is difficult to see why the courts should not apply it as well where the law is unconstitutional as where it is constitutional.

In order that the doctrine may be applied, not only must there be a law which confers corporate privileges, but it must appear that the associates have acted as if under the protection of the franchise. This thought is expressed in the phrase that the associates will not be protected unless there is "proof of user" of corporate franchises. Implied in this statement is the thought that they must have brought themselves into some relation to the state by conduct evidencing an intention to act under a special charter,¹¹ or by filing a certificate of incorporation under a general law. It has already been pointed out that there may be defects in organization so trivial that a judgment of ouster would not be pronounced against the associates in a proceeding instituted by the state. Other irregularities are so serious that the associates will, if the state proceeds against them, be ousted from the exercise of the privileges which they claim. An attempt is made in the cases to draw a distinction between different irregularities of the latter class. In some cases the irregularity before the court is said not to be such as will be inquired into under the operation of the collateral attack doctrine. In other cases the doctrine is not regarded as affording protection to associates who in the opinion of the court have altogether failed to bring themselves within the terms of the statute. To make a rational classification of these cases is obviously impossible. A practical distinction may be made between those in which a certificate of incorporation has been filed and those in which this step has not been taken.¹² The tendency of the courts is to limit the protective effect of the doctrine of collateral attack to cases of the former class. In *McLennan v. Hopkins*¹³ the Court said:

¹¹ *Railroad Co. v. Cary*, 26 N. Y. 75 (1862).

¹² See, for example, the language of Sterrett, C. J., in *Guckert v. Hacke*, 159 Pa. 303 (1893).

¹³ Kan. App. 260 (1895).

“The attempt to incorporate referred to in that case [*Pape v. Capitol Bank*, 20 Kan. 440] must be something more than mere physical organization or formal arrangement into a working force of the promoters of the enterprise. Something must be done beyond the mere transaction of the business in the manner and form usually adopted by corporations. There must also be something more tangible and effective than a mere mental operation in the direction of what is intended.”

The same problem is dealt with in a different form when an attempt is made to distinguish between those provisions of the chartering act which are to be construed as conditions precedent and those which are to be treated as conditions subsequent to the grant of corporate privileges. A statute provided that no act of incorporation should take effect until the incorporators had paid a tax into the public treasury. An organization had been effected, the tax was unpaid, and A became a stockholder. B recovered judgment against the association and issued execution against A's land under a provision in the act making stockholders liable in case of failure to file a certain certificate in each year. A sought to enjoin the execution on the ground that incorporation had never been effected. The court were of opinion that the existence of the company as a corporation might be questioned in a collateral proceeding because “the act of incorporation being inoperative there never was any corporation to incur forfeiture or any charter to be forfeited.” They were further of opinion however that A was “estopped” from denying the existence of the corporation and that his property was subject to levy and sale.¹⁴ For the statute under discussion in the above case there was subsequently substituted by the Rhode Island Legislature a provision that “no corporation shall be organized under a charter until the petitioners . . . shall pay into the general treasury for the use of the state one hundred dollars.” The same court which decided the *Slocum* case held that the changed language was

¹⁴ *Slocum v. Providence Steam and Gas Pipe Co.*, and *Slocum v. Warren*, 10 R. I. 112, 116 (1871). This case, in so far as the question of estoppel is concerned, is discussed *infra*, p. 424.

to be construed as requiring something to be done after the charter had gone into effect and that non-compliance with the requirement could be taken advantage of only by the state.¹⁵ The general tendency in modern cases is to diminish the number of irregularities which will result in subjecting the associates to liability and to construe statutory provisions as conditions subsequent rather than as conditions precedent.

In applying the doctrine of collateral attack the question arises whether the doctrine extends only to the case of statutory associations deemed to be corporations by the legislature or whether it extends also to statutory associations of whatever kind. In *Eliot v. Himrod*¹⁶ the Supreme Court of Pennsylvania declined to give the benefit of the doctrine to persons associated under a statute providing for the formation of companies with limited liability styled "partnership associations" by the legislature.¹⁷ In *Staver Mfg. Co. v. Blake*¹⁸ protection from liability was afforded to members of a similar association and the court declined to follow the Pennsylvania rule. The decision, however, was based not upon the principle forbidding collateral attack but upon a doctrine of so-called estoppel. It should seem that a substantial distinction might be drawn between associations against which the state may proceed by quo warranto or information in the nature thereof and those which are not subject to the exercise of these extraordinary remedies. In the latter instance, since there can be no *direct* attack the conception of *collateral* attack becomes impossible.

It is an important question whether the doctrine can be invoked by those who are themselves guilty of the irregularities or whether it is available only for those who are their innocent associates or successors. In *Paterson v. Arnold, supra*, the court undertook to make a distinction and granted immunity only to those who had had no part in forming the irregular association. In *Cochran v. Arnold* this distinction was swept away and immunity was conceded to all alike.

¹⁵ *Hughesdale Mfg. Co. v. Vanner*, 12 R. I. 491 (1880.)

¹⁶ 108 Pa. 569 (1885).

¹⁷ Act of June 2, 1874, P. L. 271. P. & L. col. 3401-3410.

¹⁸ 69 N. W. 508 (1896).

On principle the latter view appears to be correct. On the theory under discussion protection is given to the defendants not because of their own merits, but because the proceeding instituted by the plaintiff is not one suitable for an inquiry into their conduct. It may be doubted, however, whether (as a practical matter) protection would be given to associates who exercise corporate privileges without any color of reason for supposing themselves entitled to them. This would seem to be the situation which courts have in mind when it is said that associates are committing a fraud upon the chartering act.¹⁹ Whether or not, upon the estoppel theory, a valid distinction can be drawn between the original associates and their innocent successors is a question which will be considered presently.²⁰

Questions respecting irregularity of organization usually relate to the formation of the group. Sometimes, however, the case presents itself in which associates continue to act in corporate form after the date fixed for the expiration of the charter. What is the legal character of these acts? No case has been found in which an attempt has been made to enforce liability under such circumstances, but in *Bradley v. Reppell*, 133 Mo. 545 (1895), the court denied effect to a deed of lands given in the common name after the expiration of the charter. As far as the doctrine of collateral attack is concerned, no sufficient reason appears why an inquiry should be permitted into the continuance of the chartered grant more than into the commencement of it. The weight of authority, however, is on the side of this decision.

Upon the whole, it is suggested that the attempt to invoke the doctrine of collateral attack to secure immunity for the members of modern business associations is altogether unsatisfactory. The reason for the rule is no longer present when corporate privileges have by a general law been put within the reach of all citizens in the community and when the state has bound itself to grant the privileges upon application without reserving discretion as to whether they shall

¹⁹ See the language of the chancellor in *Stout v. Zulick*, 48 N. J. Law, 599 (1886).

²⁰ *Infra*, p. 427.

be given or withheld. Moreover, the doctrine, as has just been seen, cannot consistently be applied to associations not regarded by the legislature as corporations; and the result is that under precisely similar conditions associates may find themselves protected if they have organized under a so-called corporation law but may find themselves without protection if organization has been effected under a statute of a different name although not distinguishable from the other in principle. Where the constitutionality of the chartering act is disputed vexed questions arise upon the decision of which the liability or immunity of the associates is made to depend. Since, by supposition, immunity might be conceded in spite of non-compliance with a constitutional statute, it is an artificial rule which denies immunity because that with which the associates do not comply is unconstitutional. The fact is that the principle of unlimited liability is nowadays regarded by business men as inconsistent with commercial interest. In all manner of ways the relaxation of the principle is making itself manifest. It is, however, a characteristic of English legal thought to deal with such a situation by assuming the principle still to exist in undiminished vigor and then to invent a fictional doctrine to check the application of the principle. It is conceived that the modern development of the collateral attack doctrine is an instance of such a fiction. It can have no permanent place in a sound legal system. Either the principle of unlimited liability must reassert itself or there must be a frank recognition that limited liability may be secured otherwise than by public grant.

In concluding this branch of the discussion, the question may be raised whether the doctrine of collateral attack has any proper reason for existing under a system in which the judiciary may declare legislative acts unconstitutional. If a court not only may but, in a proper case, *must* in a collateral proceeding nullify a statute, it is a strange policy which denies to the court the right to inquire whether the provisions of a valid statute have been complied with.

3. (a) The plaintiff who seeks to enforce the liability of principals against the associates may, however, be met by a

defence of an entirely different character from that which has just been discussed. In many cases it is said that the plaintiff is "estopped" from asserting an unlimited liability against the defendants. This statement either means nothing more than the assertion that the plaintiff is stopped or precluded from recovering (which is obviously not a reason for the conclusion but a mere assertion thereof), or it means that the familiar elements of an estoppel by conduct are present, or it means that the plaintiff is not in a position to enforce a larger liability against the associates than they in fact authorized their agents to subject them to. In a few cases the elements of a true estoppel may be detected, but in most of the cases in which the term is used its use is either meaningless or is referable to the agency principle just mentioned. If it appears that at the time he made the contract in suit the plaintiff knew of irregularities in the defendants' organization, and that the defendants did not know of them and could not have ascertained them by reasonable diligence, a case of true estoppel might be made out.²¹ On the other hand, if the plaintiff did not know of the irregularities and the defendants either knew of them or might have known of them, it does not seem reasonable to say that the plaintiff is estopped. On such a state of facts the courts, however, often advance a doctrine of estoppel to explain a decision favorable to the associates.²² If the plaintiff not only did not know of the irregularities, but did not know that the defendants even purported to be organized in corporate form, it is clear that no estoppel can be asserted.²³

If the plaintiff believes the corporation to be regularly organized and the defendants are cognizant of defects, it is still clearer than in the former case that no estoppel arises in favor of the defendants.

The situation which most often presents itself is that in which all parties believed the organization to be regular at

²¹ No reported case has been found which presents this state of facts.

²² *Snider's Sons Co. v. Troy*, 91 Ala. 224 (1890).

²³ *Guckert v. Hacke*, 159 Pa. 303 (1893); *New York, etc., Bank v. Crowell*, 177 Pa. 313 (1896).

the time the plaintiff gave credit to the defendants. It is probable that the case thus supposed does not differ from the case suggested above in which the associates know of the irregularities or might ascertain them by reasonable diligence. From this situation the elements of estoppel by conduct are absent. A sells goods to the D company and subsequently sues B and others as principals, averring that D was never in fact incorporated. A demurrer is filed to a plea setting out certain steps towards an incorporation and alleging that the debt now sued for was contracted by D as a corporation and not otherwise and that A dealt with D as a corporation and not as a partnership or association of individuals. The court decides that this demurrer should be overruled. "It is conceded," said the court, "that the rule (*i.e.*, of estoppel) has been invoked and applied most frequently in suits against the stockholders of a corporation or persons who have contracted with them where the stockholder or corporation or person is seeking to avoid a liability by denying the legality of the corporate organization. But why should it not be applicable in other cases? . . . Why should not the estoppel be mutual?"²⁴

It is submitted that when a court reaches the conclusion that both parties to a transaction are estopped the true basis of the decision is not the doctrine of estoppel, but the idea of a contract obligation between the parties or a recognition that the associates have in fact created a corporate organization and have thus displaced the principle of unlimited liability. In the case last cited the court seem to have been aware that their expanded doctrine of estoppel shades insensibly into contract obligation. "When a party," the opinion proceeds, "deals and contracts with a corporation as corporators, exemption from individual liability enters as an element of the contract." At this point the judge seems to fear that the implication of limited liability from intention may operate too broadly, as, for example, in the case of persons who have assumed the status of partners without intending to be liable. The judge therefore observes: "A

²⁴ *Snider's Sons Co. v. Troy, supra.*

corporation *de facto* has an independent status recognized by the law as distinct from that of its members. A partnership is not the necessary legal consequence of an abortive attempt at incorporation." This opinion is a peculiarly interesting one, for it will be observed that the court take in succession all the positions which it is possible to take in favor of the immunity of the defendants. In the earlier part of the opinion the collateral attack doctrine is relied upon. Then the court works out an estoppel. Next there is a suggestion of a contract and finally there is a dim recognition of incorporation as resulting from the act of the associates notwithstanding a failure to conform to the requirements of the chartering statute.

In *Slocum v. Warren* ²⁵ the question was whether irregularity in organization was available as a defence to a stockholder against whose separate estate execution was issued under the provisions of a statute imposing unlimited liability in certain cases. It does not appear to have been disputed that the associates had engaged in business and that the debt in question was contracted in the regular course of business. Under these circumstances the stockholder was clearly liable. If no corporate organization were regarded as existing, the stockholder was subject to unlimited liability like any other principal. If, however, incorporation had been attained, he was liable in accordance with the provisions of the statute. The court were of opinion that no incorporation had been effected and proceeded to reason thus: "The question then is whether the stockholder who does nothing but hold his stock is estopped when pursued by a creditor of the supposed corporation from denying its existence. We think he is so estopped. By becoming and continuing a stockholder he holds himself out as a corporator and so contributes to the belief that the company with which he is associated is a corporation." In the cases heretofore examined the question whether or not incorporation has been effected has been the vital question. Here the question really

²⁵ 10 R. I. 112, 116 (1871). This case was discussed *supra*, p. 418, in connection with the subject of collateral attack.

became immaterial because the privilege of limited liability was by statute, under certain conditions, denied to the members of incorporated groups. To introduce the conception of estoppel into such a case is to give an artificial reason for reaching a sound conclusion.

A question somewhat similar to that presented in *Slocum v. Warren* was considered in *Eaton v. Aspinwall*.²⁶ The court declared that a stockholder was precluded from setting up an irregularity in organization as a defence to an action charging him with statutory liability as a shareholder in a steamship company. It appears that the business was actually launched and that the defendant had attended a meeting of the stockholders and had taken part in their proceedings. Whether or not incorporation had been effected, he was liable. The court, however, preferred to base his liability on the conception of a reciprocal estoppel.

In *Utley v. Union Tool Co.*²⁷ a statutory liability was sought to be imposed upon a stockholder who defended on the ground that the corporation had been irregularly organized. The court were of opinion that the defendant was not liable, as there was "an absolute want of proof that any corporation was ever called into being which had the power of contracting debts or of rendering persons liable therefor as stockholders." Such a decision can best be defended on the theory that the plaintiff's right to recover in the form of action which he invoked was dependent upon proof of incorporation. That the court did not mean to deny the possible liability of the defendant if an action were brought against him as a principal appears from the concluding paragraph of the opinion: "We are not called on now to say whether the plaintiffs have any remedy for the collection of their debt against those who participated in the transactions connected with the attempted organization of the supposed corporation. It is sufficient for the decision of this case that the respondents cannot be held liable in the action for the debts of a corporation which has never had any legal existence."

²⁶ 19 N. Y. 119 (1859).

²⁷ 11 Gray 139 (1858).

In the last analysis it appears that the elements of a true estoppel are wanting in most of the cases in which that term has been invoked to explain the decision. It is clear, however, that implicit in these decisions is the view that not much sympathy should be wasted on a plaintiff who was willing to accept limited liability when he made his bargain. He is not harmed if the associates are given the immunity which he believed them to possess. When the associates chose the officers or agents through whom they contracted with the plaintiff, they certainly did not give these agents authority to subject them to anything more than a limited liability. If the agents had no authority to pledge the entire estate of the stockholder, on what ground can the plaintiff rest his claim? If it be said that secret restrictions upon an authority apparently general are unavailing against third persons, the answer is that here there was no appearance of a general authority. The plaintiff walked with his eyes open into a bargain with agents who appeared to have, and in fact did have, nothing but a limited authority. The situation suggests the analogy of a plaintiff who is not permitted to hold the defendant liable for negligence because his own negligence has contributed to the result. If the plaintiff did not know that the associates were organized in corporate form, the suggested defence would not be available. If the plaintiff dealt with the defendants directly and not through agents, the question under consideration would not arise. The problem is one of agency. Let it be supposed that X and others propose to organize a bank. They effect a corporate organization but, in fact, obtain no charter. X represents to B that the bank is regularly incorporated. B subscribes to several shares of stock on the basis of this assurance. He receives dividends but takes no part in the management of the business. X and the other officers carry on the business in corporate form and A makes a deposit in the belief that the institution is an incorporated bank. A subsequently ascertains the facts and sues B for his deposit. Here B never gave to X anything but a limited authority. The plaintiff is in no better position than a plaintiff who deals with a general

agent but, in fact, has notice of a specific restriction upon his authority. B should not be held liable to A.²⁸

It was suggested, when the subject of collateral attack was under discussion, that no distinction should be made between original associates irregularly organized and their innocent successors. On the footing of agency, however, there is room for a distinction. If the plaintiff makes his contract with participants in the irregular organization, the circumstances may or may not be such that these participants will be subject to unlimited liability. If they are not, of course their innocent successor will not be. But even if the original participants could have been held liable by a plaintiff who dealt with them, it does not follow that a plaintiff who deals with the agents acting for the innocent successors can enforce an unlimited liability. The problem again becomes a problem of agency; and again it may be said that the defendants have given nothing but a limited authority and that the plaintiff has in no way been misled.

The doctrine of collateral attack has now been examined and has been found unsatisfactory. The precedents in which the elements of a true estoppel are present are so rare as to be almost a negligible quantity. It follows that, if a case is one in which the agency principle cannot be invoked, the defence must fail unless it can be sustained on one or the other of the theories which it is now proposed to consider.²⁹

3. (b) The conception of a contractual limit to liability has been discussed incidentally when the doctrine of estoppel was under consideration. Stated in its simplest form, this doctrine is that the plaintiff who has contracted with associates purporting to be incorporated is confined to a

²⁸ Upon the facts stated in the text the Supreme Court of Pennsylvania have refused to permit a recovery. *Hallstead & Coleman*, 143 Pa. 352 (1891); *Gibbs's Estate*, 157 Pa. 59 (1893). It is submitted that the decision can be sustained only on the ground just stated or on the ground (presently to be discussed) that associates attain immunity by forming a corporate group even if the organization is unlicensed.

²⁹ For the suggestion that in many of the so-called estoppel cases the courts are perhaps unconsciously applying the agency principle and for the justification of the decision in *Gibbs's Estate* (*supra*) on this theory the writer is indebted to Mr. Henry S. Drinker, Jr., of the class of 1904 in the Law School of the University of Pennsylvania.

recourse against the common fund in virtue of an implication to that effect in his contract. Where the question relates merely to the right of the plaintiff to sue the associates in their common name or their right to bring suit in that name the contract theory is of much more simple application than is the case where liability is under discussion. If the parties have made a written contract in which the associates are described by a name fairly indicative of corporate organization, it may be said with some reason that the associates have impliedly agreed to submit to suit in the common name and that by a similar implication they have a right to sue as plaintiffs in that name. To assert, however, that the plaintiff really meant to give up substantive legal rights against the individual associates in case such rights were his and that the associates really intended to stipulate for protection from unlimited liability is to strain the contract conception almost to the breaking point.

As has been seen, however, the doctrine is not without support in the cases. In *Snider's Sons Co. v. Troy*.³⁰ the contract theory is invoked in aid of the decision. In *Stout v. Zulick*³¹ A sued B and others for the price of goods sold to the X company. Recovery was refused. The opinion commingles almost indistinguishably the contract conception with the collateral attack theory and the estoppel doctrine. The contract conception is, however, definitely present, it being, of course, conceived that the parties to the contract were A and the corporate entity. "It will be seen," said the court, "that the goods were not sold to the defendants but to the company." And again, "The contract was not with the defendants, but with the company, and the defendants were guilty of no fraud." In *Guckert v. Hacke*³² a plaintiff was permitted to recover against associates who had failed to record their charter in accordance with the provisions of the general corporation law. After observing that no estoppel could be asserted because plaintiff had no knowledge of the existence of the charter,

³⁰ *Supra*, p. 423.

³¹ 48 N. J. L. 599 (1886).

³² 159 Pa. 303 (1893).

the court discussed the effect of the taking by the plaintiff of a note in the corporate name to evidence the indebtedness which had already been created. "In the absence of an express agreement," the court say, "the acceptance of a note from the defendants as a corporation after plaintiff had performed his part of the contract cannot operate by way of election or estoppel. The relation of the parties was fixed by their status when the original contract was made and cannot be changed by gratuitous inference." It should seem that the conclusion thus reached would be reached also if the defendants were asserting immunity by contract: that is to say, it would be held that their immunity or liability depended upon the contract as originally made and not upon the terms of a note subsequently given to evidence the obligation.

It should seem to be a legitimate application of the contract theory to hold that, if limited liability is a term of the contract, this term will be enforced not only between the original parties, but between assignees of both or between one of them and the assignee of the other. The doctrine would not, however, be applicable to a case in which the contract as originally made was between two individuals and the promisor is sued by a defectively organized group of associates claiming to be assignees of the promisee. As will be seen hereafter, there is authority for the obviously just view that under such circumstances the defendant is liable to the associates upon the note.³³ But such a case cannot be explained upon the contract theory.

Not only does the contract theory assume an intention in many cases where there is no intention in fact and not only is it inapplicable in cases in which the associates appear as assignees of one of the parties, but the theory fails to take account of the situation presented when the liability sought to be enforced is not contractual in its character. Suppose that the servant of the associates commits a tort in the regular course of the business which they are carrying on in corporate form and the question is whether A,

³³ *Pape v. Capital Bank*, 20 Kan. 440 (1878).

the injured plaintiff, can enforce unlimited liability against the associates. The contract theory obviously furnishes us with no principle upon which such a problem can be solved. The same observation may be made with respect to the estoppel doctrine. In such a case the associates are liable unless they are protected by the collateral attack doctrine or unless it be conceded that unlimited liability is displaced when corporate organization has in fact been accomplished. If the objections made above to the collateral attack doctrine be regarded as valid, there is no ground on which the associates can resist liability except such as is afforded by a recognition of the theory last referred to.

An interesting variation of the tort problem arises when associates organize irregularly under the law of one state and then do business in another state which does not sanction incorporation for the pursuit of the business in which they are in fact engaged. In such a case, if an agent commits a tort in the second state, the question will arise whether unlimited liability can be enforced by the injured plaintiff against owners of shares in the property or business of the group. As neither estoppel nor contract is available for the stockholders' protection, the question is whether he can invoke the collateral attack doctrine or the theory of private incorporation. The theory of private international law that by comity effect will be given by one state to the legislation of another is qualified by the proviso that such legislation must not be inconsistent with the policy of the state which is asked to give effect to it. The collateral attack doctrine has never been and probably never will be extended so far as to preclude an inquiry into the question whether such inconsistency exists. The effect of the mere absence of a law authorizing incorporation in the second state for the purpose in question might or might not be regarded as equivalent to the absence of a law authorizing such incorporation in the first state. If, for example, state A authorizes incorporation of a drainage company and state B does not, it is conceivable that a court in state B might or might not regard the absence of statutory authority for such incorporation as an indication of hostility to groups

of that class.³⁴ If, however, the legislation of state B not only does not authorize incorporation for the purpose of that business, but makes regulations for its conduct which manifest an intention that it shall not be carried on by corporate groups, or not by foreign corporate groups, it seems clear that no effect should be given by a court in state B to the legislation of state A; under such circumstances the result is that there is no law in state B authorizing incorporation. In a situation of this kind the collateral attack doctrine can have no application.³⁵

It also seems clear that in the suggested case no theory of private incorporation should be permitted to protect from individual liability associates who have sought to organize themselves in pursuit of a business which consistently with the law of the state cannot be carried on in corporate form.

If neither the collateral attack doctrine nor the theory of private incorporation is available as a defence, the stockholder must respond to the plaintiff in damages in virtue of his position as an undisclosed principal.³⁶

3. (c) As a result of the discussion of the collateral attack theory and of the estoppel and contract doctrines it appears that no one of them furnishes a satisfactory basis upon which to rest the immunity of the associates in *de facto* corporation cases. The very cases, however, which profess to apply one or another of these doctrines are cases in which an entirely different doctrine is seen to be struggling for recognition. It is the doctrine that the usual incidents of incorporation are attainable without concession from the state by associates who form a group with a repre-

³⁴ In fact, the law appears to be settled in favor of the recognition by state A of the corporate right of persons associated under the law of state B when the law of A makes no provision for incorporation for the purpose in question. See *Cowell v. Colorado Springs Co.*, 100 U. S. 55 (1879).

³⁵ *Davis v. Stevens*, *supra*, p. 416.

³⁶ Let it be supposed that A contracts in state B with the agent of associates organized under the laws of state C who have not registered in B as required by the foreign corporation law of that state. A should be permitted in B to hold the associates liable as principals. A possible view is that the agent, having no incorporated principals in B, may himself be held liable without limit by a court sitting in B. A decision to this effect is *Lasher v. Stimson*, 145 Pa. 30 (1892).

sentative organization and actually conduct business in corporate form. Our attention is thus called to a wide-spread tendency to displace the unlimited liability which by the common law is imposed upon every one for acts done by him or by another in his service. As a matter of fact, unlimited individual liability, although spoken of with reverence by many authorities,³⁷ is regarded as of relatively small importance in modern business. One who lends money without security is regarded, except under peculiar circumstances, as inviting the loss which usually follows. Indeed, it is not uncommon to hear one who lends without security blamed for putting the borrower in a false position by lending him money which there could be no real expectation of getting back. The note or bond accompanying a mortgage has come to be considered a small element of security. It is usual for a borrower to convey his property to a man of straw who executes the bond and mortgage and reconveys the property subject to the lien. It is becoming more and more easy for stockholders whose stock is not full paid to escape further liability by transfers made for that very purpose. Limited liability is regarded as a matter of course in all manner of statutory associations. Whether the policy of the legislatures in making the limitation so general is responsible for the contemporary view of the subject or whether legislation merely reflects the economic tendency is a question not easy to answer. In such matters legislation is usually less radical than the average public opinion. The courts made an important contribution to this most dangerous result when they perpetuated the idea approved by Blackstone that incorporation necessarily involves a limitation of liability. Neither historically nor on principle is there necessity for such a conception, but it has become part of our law.³⁸ The modern law on this point, both in England and in the United States, whether it be wise or unwise, is stated by Cave, J., in com-

³⁷ *E.g.*, Lindley Comp. 354 (6th Ed.).

³⁸ *Carr v. Iglehart*, 3 Ohio St. 457 (1854). Blackstone (Bk. I, c. 18, p. 485, Lewis's Ed.) adopts the maxim of the civil law, "*Si quid universitati debetur, singulis non debetur; nec, quod debet universitas, singuli debent.*"

menting upon the argument of counsel for creditors in *In re Sheffield and South Yorkshire Permanent Bldg. Soc.*³⁹

“He argued that persons who unite together for trading or making profits in any way are at common law liable for all debts which are incurred during the time they are members of the association, and that, if the association has ultimately to be wound up, past members must pay their shares of the debts. As a general rule—apart from legislation—that is perfectly true with respect to partners, and to associations in the nature of partnership where there is no incorporation, but with respect to corporations the case is entirely different when the legislature has not thought fit to intervene, or where the charter under which the body is incorporated does not provide otherwise. A corporation is a legal *persona* just as much as an individual; and, if a man trusts a corporation, he trusts that legal *persona*, and must look to its assets for payment: he can only call upon individual members to contribute in case the act or charter has so provided.”⁴⁰

This assumption that limited liability is a necessary incident of incorporation is believed to be the source of much

³⁹ 22 Q. B. D. 476 (1889).

⁴⁰ The dangers incident to the restriction of individual liability are well stated by Gibson, J., in *Hess v. Werts*, 4 S. & R. 356 (1818). “The absolving of corporators from personal responsibility has always a greater or less tendency to fraud. While there is a divided responsibility to public opinion, the odium due to misconduct is banded from one to another, till at length it rests nowhere; and we sometimes see men do things in a corporate character which, as individuals, they would blush to be thought capable of. Hence, a necessity of holding them in check by individual interest. Private associations, therefore, attempting to arrogate to themselves the attributes of a corporation are entitled to no indulgence, and more particularly this association, which carried on its operations in open defiance of the laws of the country. An exemption from individual liability is the most substantial benefit derived from a charter; the having perpetual succession, ability to sue and be sued, corporately, etc., are only matters of convenience that may be dispensed with. The defendants attempted, if they designed this clause for individual exoneration, to secure to themselves the substantial benefit of a corporate character in a business forbidden by law to all but corporate bodies. They have, therefore, no claim to an indulgent construction; and I am of opinion the legal meaning of the contract is that they are personally liable.”

The case was one in which members of an association styled “The Farmers’ and Mechanics’ Bank” were held liable as principals on certain notes in the nature of bank-notes containing a promise to pay “out of their joint funds according to their articles of association.”

of the difficulty of the subject. *Incorporation really has to do with modes of action, not with consequences of action.* When associates are incorporated they may act and be acted upon in accordance with representative principles. The right to form a highly organized group ought not to be regarded as derivable only from the state. But the right to secure immunity from liability is a right which ought not to be acquired except by public consent. Were it not for the insistence that incorporation involves the idea of limited liability the problem of irregular organization would be relatively easy of solution. As respects all rights but that of limited liability it could be said without much hesitation that the associates had in fact attained them by organizing a corporate group, whether or not they had organized regularly. As respects limited liability it should be said that the limitation could be had only by legislative grant and that the associates had not satisfied the terms of the grant. But it might further be said that the plaintiff must establish his rights in a suit against the associates in their common name because the obligation is corporate, leaving him free to enforce individual liability under the common judgment. As to the mode in which, after judgment against the group, liability might be enforced against the individual member, the development might take place along either of two lines: (1) the partnership mode, by execution against either common property or the separate estate or both; (2) the corporation mode, by access to the separate estate (either in equity, by action at law, or alias execution) only after the common fund has been exhausted.⁴¹

It being the fact that limited liability is by modern custom accorded to many debtors, and it being conceded that limited liability is nowadays an incident of regular statutory organization, the important question is whether limited liability can be attained by irregular as well as by regular organiza-

⁴¹ This suggestion respecting the plaintiff's obligation to establish his claim in a suit against the associates in their common name would have nothing but an academic interest were it not for the fact that some such conception appears to have been in the mind of the courts which decided *Utley v. Union Tool Co.* (*supra*, p. 425), and *Gibbs's Estate*, *supra*, p. 427.

tion? To answer the question in the negative is to refuse recognition to the conditions which result from the American decisions. To give an affirmative answer is (excepting where the defendant's immunity can be explained on agency principles) to recognize the possibility of incorporation by the private act of the associates. To choose between these two alternatives is a responsibility which courts cannot escape. Longer to make fictional applications of a collateral attack theory and an estoppel doctrine is inconsistent with intellectual self-respect. To develop the contract theory is to give the name of contract to an obligation not really consensual. Therefore it is necessary to choose between adherence to the common-law principle of unlimited liability and a view which enables associates to limit their liability but leaves the state free to regulate the conditions under which the limitation may be lawfully effected. Frankly to abandon the unhistorical concession theory and to limit the function of the state to the regulation of associations formed by the parties is to furnish a rational explanation of a mass of cases in which collateral attack and estoppel and contract are at present mingled in distressing confusion.

In *Staver Mfg. Co. v. Blake* (*supra*) the court makes this observation: "If these defendants in the absence of any statute had associated themselves upon the same terms as those provided by this statute, had limited their liability in the same manner and for the same amount, had furnished plaintiff with a copy of that agreement, and he had sold them goods, the law would not permit him to recover against them either as individuals or as partners." If the court means that the creditor would under such circumstances be notified of a limitation upon the authority of the agents of the group, the observation is sound. If the court means more than this, the only rational ground upon which to base the result is the possibility of attaining incorporation by private act notwithstanding irregularities in the organization. The same remarks may be made of *Gibbs's Estate*,⁴² in which the Supreme Court of Pennsylvania gave

⁴² *Supra*, p. 427, 157 Pa. 59 (1893).

immunity to one of several coproprietors of a banking business by declaring that the plaintiff, a depositor, had not discharged the burden of proving the defendant a partner. The conception of private incorporation is immanent in *Society v. Cleveland* (*infra*) and in *Snider's Sons Co. v. Troy* (*supra*). In case after case results are ascribed to the operation of principles which, upon analysis, are found not to be applicable. It remains for the courts to recognize and avow the real significance of their own decisions or else render those decisions obsolete by enforcing liability in every case in which there has not been substantial compliance with a constitutional statute. By "substantial" is meant such compliance as would be regarded as sufficient to prevent a judgment of ouster from going against the associates.

To make a wise choice between these alternatives requires that a judge shall consider the economic consequences of an abolition of unlimited liability. To remove the sanction of unlimited liability is to do in the field of law that which is analogous to the weakening, in the domain of ethics, of the sense of personal accountability. In the opinion of the writer, legislative grants of limited liability have been far too freely made in this country. The courts have only aggravated the evil by conceding immunity in cases of irregular organization. A judge may, however, well conclude that as a practical matter the mass of precedent cannot be disregarded and that he will recognize incorporation by private act and leave it to the legislature to punish those who limit their liability without a license. Upon this view of the situation the inquiry in each case should hereafter be whether the associates have in fact organized a group in a form for which a charter or license might be had upon proper application and for a purpose not inimical to the welfare of the community. If they have, the next inquiry should be whether they have actually begun business and acted through the agencies common to associations of their type. If so, limited liability and such other privileges as will be licensed upon application should be recognized as pertaining to the associates. Their status should be assimilated to that of a man and a woman who, without license or ceremony, co-

habit and announce themselves as husband and wife. Their children are legitimate and the consequences of marriage follow in respect to their property rights. To regulate marriage, however, is an important duty of the state, and to punish unlicensed marriages is an unquestionably sound policy. So likewise is it of the utmost importance that the state should regulate association and incorporation. The formation of statutory groups otherwise than in accordance with statutory provisions should be made a penal offence and the penalty should be strictly imposed.⁴³

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(To be continued.)

⁴³ In England the results last above outlined have been reached by legislation. The following provisions are made by c. 48 of 63 and 64 Vict. by way of amendment to the Companies Acts: "Incorporation and Objects. 1. (1) A certificate of incorporation given by the registrar in respect of any association shall be conclusive evidence that all the requisitions of the Companies Acts in respect of registration and of matters precedent and incidental thereto have been complied with, and that the association is a company authorized to be registered and duly registered under the Companies Acts.

(2) A statutory declaration by a solicitor of the High Court engaged in the formation of the company or by a person named in the articles of association as a director or secretary of the company of compliance with all or any of the said requisitions shall be produced to the registrar, and the registrar may accept this declaration as sufficient evidence of such compliance.

(3) The incorporation of a company shall take effect from the date of incorporation mentioned in the certificate of incorporation.

(4) This section applies to all certificates of incorporation, whether given before or after the passing of this act.

Sec. 28 of the same act is as follows: "If any person in any return, report, certificate, balance sheet, or other document, required by or for the purposes of this act, wilfully makes a statement false in any material particular, knowing it to be false, he shall be guilty of a misdemeanor, and shall be liable on conviction on indictment to imprisonment for a term not exceeding two years, with or without hard labor, and on summary conviction to imprisonment for a term not exceeding four months, with or without hard labor, and in either case to a fine in lieu of or in addition to such imprisonment as aforesaid: Provided that the fine imposed on summary conviction shall not exceed one hundred pounds."

The effect of this enactment is in great measure to banish the question of irregular organization from the realm of private litigation in England. The statute does not, however, provide for the case in which there has been a failure to obtain a certificate. By implication it may be concluded that in such a contingency the associates could lay claim to no corporate privileges whatever.